Foreign Exchange Exposure in Emerging Markets

How Companies Can Minimize It

Gastón Fornés

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University of Bristol (UK) and ESIC Business and Marketing School (Spain)

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First published 2009 by
PALGRAVE MACMILLAN

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Palgrave Macmillan in the US is a division of St Martin's Press LLC, 175 Fifth Avenue, New York, NY 10010.

Palgrave Macmillan is the global academic imprint of the above companies and has companies and representatives throughout the world.

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ISBN-13: 978–0–230–20260–3 hardback
ISBN-10: 0–230–20260–8 hardback

This book is printed on paper suitable for recycling and made from fully managed and sustained forest sources. Logging, pulping and manufacturing processes are expected to conform to the environmental regulations of the country of origin.

A catalogue record for this book is available from the British Library.

Library of Congress Cataloging-in-Publication Data
Gastón, Fornés, 1971–
Foreign exchange exposure in emerging markets : how companies can minimize it / Gastón Fornés.
p. cm.
Includes bibliographical references and index.
ISBN 978-0-230-20260-3
1. Foreign exchange rates–Developing countries. 2. Developing countries–Economic conditions. 3. Corporations, European–Finance. I. Title.
HG3877.F67 2008
332.4'56091724–dc22 2008020804

10 9 8 7 6 5 4 3 2 1
18 17 16 15 14 13 12 11 10 09

Printed and bound in Great Britain by
Antony Rowe Ltd, Chippenham and Eastbourne

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To Claudia

To my parents

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Acknowledgements

First, I would like to thank the organizations that financially supported this project, the AlBan Programme from the European Union (high level scholarships for Latin America, identification number E03D21204AR), the University of Bath's School of Management, and ESIC Business and Marketing School. I also want to thank the Department of Politics at the University of Bristol for giving me the flexibility to work on this research.

Second, I would like to express my gratitude to the persons and organizations that, in different ways, helped me during this process: the University of Bath (especially the Research Support Unit), the School of Management, the Universidad del Desarrollo in Chile, the Consejo Empresario Mendocino, the IAE, the Alta Direccion Escuela de Negocios in Argentina, and all the persons and companies that took part in the survey.

Third, I am pleased to acknowledge the support received from the Euro-Latin American Centre at the Instituto de Empresa Business School in Spain; especially from its Director, Prof. G. Cardoza. His cooperation and guidance during the data collection stage in Madrid, along with the comments and engaging discussions when producing the paper presented at the EIBA conference in Oslo, created a place for deep reflections over the course of the last two years.

Fourth, I would like to thank Prof. Rafael Ortega and Prof. Segundo Huarte from ESIC; their support during the latest stages of this work is really appreciated.

Finally, and most importantly, I would like to thank Dr Alan Butt-Philip; without him this work would not have been possible. Alan, thank you very much, I am endlessly grateful.

Gastón Fornés

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Introduction

> To my knowledge no model projecting movements in exchange rates is superior to tossing a coin.
>
> Alan Greenspan[1]

1.1 Context and motivation

This quote from Alan Greenspan highlights just how difficult it is for companies operating with different currencies to project the variations in the exchange rate. Dealing with different currencies began to be an issue for companies and governments principally after the end of the Bretton Woods system in 1973 and has been the reason behind many important political and economic agreements – one prime example being the European Union's (EU) Economic and Monetary Union (EMU) and the launch of the euro. The increase in international trade and investments following the end of the Second World War encouraged companies find new ways to deal with this issue, especially after 1973. Financial tools were developed to hedge currencies and strategies and organizational forms were proposed to protect the firm's value against unanticipated variations in the exchange rate.

Nevertheless, fluctuations in the exchange rate continued to be a major issue for companies and a new challenge appeared when what are now known as the emerging countries increased their share of international trade and became recipients of large amounts of foreign investment. The rise of the Latin American economies (principally Argentina, Brazil, Chile and Mexico), some Asian Pacific countries, and East European states following the dissolution of the Soviet Union in the 1990s, along with the economic emergence of China, India, and Russia in the first few years of the twenty-first century, are good examples of the increasing importance of these markets in the global economy. In this context, the economic integration among these emerging regions and industrialized countries has continued growing through more trade and investments as well as through the signing of Free Trade Agreements (FTAs) and the accession of many of these countries to the World Trade Organization (WTO).

As a consequence of this upward trend in investments and trade, for example, Western European companies became the largest investors in some of these regions, principally Latin America and Eastern Europe, and have also established significant positions in other emerging countries, such as India and Russia. But these positions did not prevent European firms from suffering as a result of the volatility in the price of these countries' currencies, especially during the economic and financial crises that occurred in Mexico (1994), Russia (1997), the Asia Pacific region (1997), Brazil (1999), Turkey (1999) and Argentina (2001) and their contagious effect on neighbouring countries.

The main sources of motivation for this work were the challenges faced by companies during currency crises in emerging markets. Many academic works have studied the foreign exchange (FX) exposure of companies from Triad countries operating in Triad countries; however, only a few were found researching this phenomenon for subsidiaries in emerging countries. On the other hand, during the years when the majority of this work was being carried out, important events occurred in relation to currencies in the global economy. For example, the consolidation of the euro, along with the loss of around 30 per cent of the value of the US dollar (against the European currency), provided specialized publications and companies with room for discussion about the different alternatives to deal with this new environment. The novelty in these discussions came from the inclusion of a debate on the value of an emerging country's currency, the Chinese renminbi.[2] The latter also shows the increasing importance of emerging markets in the international economy and therefore provided an extra source of motivation for this work.

Within the framework of these motivations, the question driving the efforts during this research was: what can companies do to protect the value of their investments in emerging markets against fluctuations in the exchange rate in a context of increasing economic integration? As mentioned earlier, the review of the literature showed that most of the research carried out in this field was focused on industrialized countries. In addition, most of them took a macro perspective (that is, one that studies industries or economic sectors). Only in recent years have the majority of the studies at the company level been published, but there has still been an overwhelming focus on the situation in developed or OECD countries.

Most of these works have concluded that because of the long-term nature of economic exposure (which is the name given to the most important, exposure resulting from the variations in the exchange rate), along with the problems encountered in trying to assess its effects accurately, their potential effects are difficult to hedge using the traditional techniques available in financial markets. Another conclusion presented by the literature is that companies should use their knowledge, assets, and skills in marketing, operations management, and finance in order to deal with this risk, and also that it must be included in the strategic planning of these areas.

It is for these reasons that the starting point of this work, and therefore its main proposition, is that a holistic approach (involving the functional areas mentioned before) to hedging against variations in the exchange rate is expected to contribute to a reduction of the impacts that these variations have in the performance of companies with foreign investments in emerging markets. The result of more than three years of work, and coinciding with the end of this project, this holistic approach has been recognised as one of the areas of future joint research between International Business and Finance, highlighting the importance of the effects of foreign exchange risk management on 'the MNE's [multinational enterprises] logistics, supply chain management, financial accounting, AIS, HR/OB, business law, and marketing functions' (Butler, 2006). Therefore, the first objective of this work is to study the movements in the exchange rate's impact on companies operating in emerging markets from a wider approach than has been taken by previous studies.

In addition, in order to answer the main question behind this research (presented in a previous paragraph), this work has also aimed to develop a tool to enable companies to improve the effectiveness of their hedging activities in emerging markets. This tool has been based on previous works on industrialized countries and has benefited from some adaptations to the emerging countries' environment based upon the data collected from companies operating in these markets. In this context, the second objective of this work is to attempt to develop a tool that helps companies to improve the effectiveness of their hedging activities in emerging markets.

Taken as a whole, the fact that foreign investments in emerging markets have continued growing with the emergence of the so-called 'BRIC' countries (that is, Brazil, Russia, India, and China), along with the recent recognition of the holistic approach taken, give current relevance to the topic under study. Furthermore, the development of a tool tailored to the companies' hedging needs is expected to have an impact on the management and performance of multinational corporations (MNCs) operating in emerging markets.

1.2 Structure

This introductory chapter is followed by a chapter on the global economy and emerging markets which aims to frame the context and also to provide some background for the analysis that forms the core of the book. This second chapter includes sections on the relative position of emerging markets in the global economy, and on the foreign investment trends in these markets, along with the main research perspectives used to analyse emerging markets.

Chapter 3 presents a review of the current literature. It begins with the main conceptual frameworks on the internationalization of companies, and then continues with the literature on foreign exchange exposure and its effects on firms' value from four different perspectives: finance, marketing, operations management, and strategic planning. The main approaches to assess the impact of exchange rate fluctuations are also included.

Chapter 4 introduces both the conceptual framework and the objectives of this work. It presents different perspectives – from finance, from marketing, from operations management, and from strategic planning. The main framework is constructed through the use of these four perspectives. The chapter concludes by giving an outline of the objectives and research propositions.

Chapter 5 shows how the analysis was carried out using the framework described in Appendix 1 at the end of the volume. It presents

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